

**TENNESSEE DEPARTMENT OF REVENUE**  
**LETTER RULING # 02-23**

**WARNING**

**Letter rulings are binding on the Department only with respect to the individual taxpayer being addressed in the ruling. This presentation of the ruling in a redacted form is informational only. Rulings are made in response to particular facts presented and are not intended necessarily as statements of Department policy.**

**SUBJECT**

Application of sales and use taxes to compressors, boilers, pallets, and sanitation chemicals used by a manufacturer.

**SCOPE**

This letter ruling is an interpretation and application of the tax law as it relates to a specific set of existing facts furnished to the Department by the taxpayer. The rulings herein are binding upon the Department and are applicable only to the individual taxpayer being addressed.

This letter ruling may be revoked or modified by the Commissioner at any time.

Such revocation or modification shall be effective retroactively unless the following conditions are met, in which case the revocation shall be prospective only:

- (A) The taxpayer must not have misstated or omitted material facts involved in the transaction;
- (B) Facts that develop later must not be materially different from the facts upon which the ruling was based;
- (C) The applicable law must not have been changed or amended;
- (D) The ruling must have been issued originally with respect to a prospective or proposed transaction; and
- (E) The taxpayer directly involved must have acted in good faith in relying upon the ruling, and a retroactive revocation of the ruling must inure to the taxpayer's detriment.

## FACTS<sup>1</sup>

[THE TAXPAYER] is registered for Tennessee sales and use taxes under [ACCOUNT NUMBER]. The Taxpayer is a manufacturer of [PRODUCTS] at its [CITY, TENNESSEE], Tennessee location. The Department of Revenue has issued an industrial machinery authorization [NUMBER] that permits the exempt purchase of industrial machinery by this Taxpayer. It is accepted for purposes of this ruling that the Taxpayer is a manufacturer principally engaged in the fabrication or processing of tangible personal property for resale and consumption off its [CITY, TENNESSEE] premises. The Taxpayer has requested a ruling as to the application of the sales or use tax exemptions that may be available in the case of several different items in use at its plant.

The Taxpayer states that boilers and air compressors<sup>2</sup> are primarily used for “direct manufacturing” of its products. The boilers are primarily used to generate electricity to operate the production line, and to [APPLY HEAT TO] the products being manufactured. The boilers are not used to heat any offices or any other portions of the Taxpayer’s plant. Approximately ten per cent (10%) of the steam from the boilers is used to produce hot water used to clean and sanitize the production lines. Production must be stopped on the machinery being cleaned and sanitized. The air compressors are used to blow underweight products off the production line. Also, the compressors are used in conjunction with machinery used to wrap the finished product. Finally, approximately ten per cent (10%) of the use of the air compressors is to clean the production line by the use of forced air. The air compressors are not portable. They are large plant compressors.

The Taxpayer also uses sanitation chemicals and supplies on its production lines. Disinfectants, brushes, etc. as required by the Federal Drug Administration are used to clean the production line equipment. The manufacturing process is halted during this cleaning.

Some of the Taxpayer’s large and important customers are retailers who require that the Taxpayer ship the finished products ([PRODUCT TYPES]) on new pallets that these customers will retain. For each delivery the products purchased are shrink-wrapped and placed on a new pallet purchased for this exclusive purpose. A pallet will hold approximately twenty-five (25) boxes weighing a total of six hundred (600) pounds, but the pallet is not shrink-wrapped or otherwise bound in any way to the products being shipped. These customers are not separately billed for the new pallets, and the charges made for the products provided are no more than the charges made for the same products sold to other customers on old pallets. Old pallets are received by the Taxpayer with its purchases of raw materials at no additional cost, and are also sometimes purchased by the Taxpayer at approximately one-half the cost of new pallets. Old pallets are used in a number of other ways at the plant. They are not exclusively used for shipments, but when used for shipments they are not usually returned.

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<sup>1</sup> The facts presented by the Taxpayer’s letter requesting the ruling were supplemented by subsequent and additional facts provided by the Taxpayer through telephone conversations and e-mail.

<sup>2</sup> The Taxpayer states each boiler is used the same way, and each air compressor is used the same way.

## **QUESTIONS**

1. (a) Are the boilers, as described, exempt from sales and use taxes as industrial machinery?  
(b) Are the air compressors, as described, exempt from sales and use taxes as industrial machinery?
2. Are sanitation chemicals and supplies used on the production line exempt from sales or use taxes?
3. Are new pallets used exclusively to ship the Taxpayer's product to customers who retain these pallets exempt from sales or use taxes?

## **RULINGS**

1. (a) Yes.  
(b) Yes.
2. No.
3. No.

## **ANALYSIS**

### **Boilers and Air Compressors**

Industrial machinery is exempted from sales or use taxes pursuant to Tenn. Code Ann. § 67-6-206(a). Industrial machinery is defined in relevant part as follows:

"Industrial machinery" means:

- (A) Machinery, apparatus and equipment with all associated parts, appurtenances and accessories, including hydraulic fluids, lubricating oils, and greases necessary for operation and maintenance, repair parts and any necessary repair or taxable installation labor therefor, which is necessary to, and primarily for, the fabrication or processing of tangible personal property for resale and consumption off the premises ... where the use of such machinery, equipment or facilities is by one who engages in such fabrication or processing as one's principal business ....

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- (D) *Such industrial machinery necessary to and primarily for the fabrication and processing of tangible personal property for resale or used primarily for the control of air pollution or water pollution includes, but is not limited to:*
- (i) *Machines used for generating, producing, and distributing utility services, electricity, steam, and treated or untreated water;*
  - (ii) *Equipment used in transporting raw materials from storage to the manufacturing process, and transporting finished goods from the end of the manufacturing process to storage;*
- (E) Machinery used to package manufactured items, where the use of such machinery is by a person whose principal business is fabricating or processing tangible personal property for resale.... To "package," as used in this subdivision, refers only to the fabrication and/or installation of that packaging which will accompany the product when sold at retail;
- (F) *Such industrial machinery necessary to and primarily for the fabrication or processing of tangible personal property for resale and consumption off the premises or used primarily for the control of air pollution or water pollution does not include machinery, apparatus and equipment used prior to or after equipment exempted by subdivision (13)(D)(ii), and does not include equipment used for maintenance or the convenience or comfort of workers;*

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Tenn. Code Ann. § 67-6-102(13)(Emphasis mine).

For purposes of this ruling, it is accepted that the Taxpayer qualifies as a manufacturer who is principally engaged at the [CITY, TENNESSEE] location in the fabrication of tangible personal property for resale and consumption off the premises. The Taxpayer possesses an industrial machinery authorization issued by the Department of Revenue for this location. While the Taxpayer is a manufacturer at its Tennessee location, not all the equipment used by the Taxpayer will qualify as exempt industrial machinery. The use of the machinery determines whether it is exempt "industrial machinery" as defined by Tenn. Code Ann. § 67-6-102(13). The Taxpayer wishes to know whether the boilers and air compressors used at its plant constitute exempt industrial machinery. The Taxpayer states the boilers are primarily used for "direct manufacturing". Specifically, the boilers are used to generate electricity and steam used to operate the production line, and to [APPLY HEAT TO] the products being manufactured. Also, approximately ten per cent (10%) of the steam produced from the boilers is used to clean and sanitize the production lines. Production must be stopped while the machinery is being cleaned and sanitized. The boilers are not used to heat any offices or other portions of the Taxpayer's plant.

Prior to 1984, the industrial machinery exemption applied only to machinery, which was “directly and primarily”, used in the manufacturing process. “Directly” was defined by the Tennessee Supreme Court as “in direct contact with, and without the intervention of any person or thing.” *Phillips & Buttorff Mfg. Co. v. Carson*, 217 S.W.2d 1, 5 (Tenn. 1949); *Woods v. General Oils, Inc.*, 558 S.W.2d 433, 436 (Tenn. 1977). However, it is no longer required that the exempted machinery come into direct contact with the raw material being physically transformed into a finished product. In 1984, the legislature broadened the industrial machinery exemption. In addition to other changes, the legislature removed the language requiring that exempt machinery be “directly” used in the manufacture of tangible personal property, substituting instead the requirement that it be “necessary to” the manufacturing process. 1984 Tenn. Pub. Acts 762. Under the more relaxed provisions of the law, it is not essential that the boilers or air compressors come into direct contact with the item being manufactured to qualify for the exemption. It is only required that the boilers be “necessary to and primarily for” the fabrication or processing of tangible personal property for resale. Tenn. Code Ann. § 67-6-102(13)(A) & (D).

In a case decided under the current law, *Tibbals Flooring Co. v. Huddleston*, 891 S.W.2d 196 (Tenn. 1994), the Tennessee Supreme Court considered whether a system of machines used in combination with boilers to generate and produce electricity and steam qualified as exempt industrial machinery. The taxpayer, a manufacturer of parquet wood flooring, contested the Department of Revenue’s use tax assessment on its spoils removal and dust piping system. This system was used to transport wood waste to boilers that actually generated and produced the steam and electricity used at the plant. The Department contended the system was subject to sales or use tax because the machines only transported the wood waste to the boilers. Taxation of the boilers was not an issue. The Commissioner conceded the boilers were exempt from the tax as industrial machinery. The Court held the spoils removal and dust piping system was also exempt as industrial machinery composed of “[m]achines used for generating, producing, and distributing utility services, electricity, steam...” pursuant to Tenn.Code Ann. § 67- 6-102(13)(D)(i). *Id.* p. 199, 200. Presumably, the spoils removal and dust piping system was also “necessary to and primarily for the fabrication or processing of tangible personal property for resale” and consumption off the premises as required by § 67-6-102(13)(D)<sup>3</sup>. However, the Court in its brief decision did not find it necessary to specifically address this additional important requirement.<sup>4</sup>

It seems clear from the 1994 *Tibbals* decision and the definition of “industrial machinery” that a boiler system used to generate steam and electricity that are “necessary to and primarily for the fabrication of tangible personal property for resale and consumption off the premises” will be exempt from sales and use taxes as “industrial machinery”. The facts presented establish that the Taxpayer’s boilers are necessary to and primarily for the fabrication of tangible personal property for resale and consumption

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<sup>3</sup> I interpret the reference to “[s]uch industrial machinery” in Tenn. Code Ann. § 67-6-102(13)(D) to incorporate the requirement that the tangible personal property be used “off the premises” as mandated by Tenn. Code Ann. § 67-6-102(13)(A).

<sup>4</sup> Since the Department conceded the exemption applied to the boiler, it appears it may have only been necessary for the Court to determine the machinery at issue was necessary to the operation of the boiler.

off the premises. Accordingly, the specific exemption afforded by § 67-6-102(13)(D) applies, and the Taxpayer's boilers are exempt as industrial machinery.<sup>5</sup>

The Taxpayer states that air compressors are primarily used on the production line to remove underweight products and in the wrapping of the finished product. Also, approximately ten per cent (10%) of the use of the air compressors is to clean machinery by the use of forced air. The uses of the air compressors are "necessary to and primarily for the fabrication of tangible personal property for resale and consumption off the premises" so as to qualify as exempt industrial machinery pursuant to Tenn. Code Ann. § 67-6-102(13)(A). Also, the use of the machinery in packaging is specifically recognized as an exempt industrial machinery activity. *See*: § 67-6-102(13)(E).

### **Sanitation or Cleaning Chemicals and Supplies**

Sanitation or cleaning chemicals and supplies used to clean the machinery when the production line is closed down are not subject to any specific exemption from the sales or use taxes. These materials are not included in any of the definitions of exempt "industrial machinery" contained in Tenn. Code Ann. § 67-6-102(13)(D). Also, these materials are not "industrial materials" that are excluded from the application of the sales and use tax by Tenn. Code Ann. § 67-6-102(24)(E)(i). Industrial materials are materials coming into "direct contact" with the manufactured product that either become a component part of the finished product or are consumed within twenty-five (25) consecutive calendar days. TENN. COMP. R. & REGS. 1320-5-1-.40. The "direct contact" still applies in the case of "industrial materials". Since the chemicals described do not meet the "direct contact" test they do not qualify for the industrial materials exemption. Finally, the fact the use of these chemicals and supplies may be mandated by the Federal Drug Administration is not a circumstance that affords an exemption under the Sales and Use Tax Law. The one hundred percent (100%) sales tax credit available for pollution control mandated by federal, state or local law is not applicable here. *See*: Tenn. Code Ann. § 67-6-346.

### **Pallets**

There are two exceptions from application of the sales and use tax that must be considered in regard to the new pallets. First, taxable "sales at retail" or "retail sales" are defined to exclude from application of the sales tax "sales for resale".

"Retail sales" or "sale at retail" means a taxable sale of tangible personal property or specifically taxable services to a consumer or to any person for any purpose other than for resale....

Tenn. Code Ann. § 67-6-102(24)(A). The "for any purpose other than for resale" language has been construed as an exception to the sales tax statute. *See: Colemill Enterprises, Inc. v. Huddleston*, 967 S.W.2d 753, 756 (Tenn.1998). Accordingly, it must

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<sup>5</sup> § 67-6-102(13)(A) would also support this exemption.

be construed against the taxpayer, and an exception from sales tax must positively appear because it will not be implied. See, e.g., *Hyatt v. Taylor*, 788 S.W.2d 554, 556 (Tenn.1990); *American Cyanamid Co. v. Huddleston*, 908 S.W.2d 396, 400 (Tenn.Ct.App.1995).

The purchases of these new pallets by the Taxpayer are not subject to sales or use tax if the vendor's sales to the Taxpayer constitute "sales for resale."<sup>6</sup>

"Sales for resale" means those whereby a supplier of materials, supplies, equipment and services makes such tangible personal property or services available to legitimate dealers actually selling such property or services as such, or which becomes an industrial material or supply in a manufacturing or processing operation.

TENN. COMP. R. & REGS. 1320-5-1-.62(1).

Clearly, title and possession of the pallets pass to the Taxpayer's large customers who require the Taxpayer to use new pallets that will be retained by them. However, from the facts presented it has not been clearly established that there is any additional charge or other consideration for the new pallets. If the pallets are given to customers, they are not purchased for resale.

In *Scholl, Inc. v. Jackson*, 731 S.W.2d 893 (Tenn. 1987), the Court held that display racks sold to Scholl, Inc. for delivery to retailers of its products were not exempt "sales for resale". Scholl made no separate charge for the racks and not all retailers of Scholl received the racks. The Court rested its decision in large part upon the fact that Scholl made no differentiation in the price it charged a retailer for its products, i.e. foot powder, etc., whether the retailer did or did not receive a display rack. *Id.* 896. While the *Scholl* case involved racks not pallets, in many respects the facts are similar to those presented here.<sup>7</sup> Since customers of the Taxpayer pay the same price for the products purchased whether or not they receive new pallets, *Scholl* indicates the new pallets are not resold.<sup>8</sup> However, there remains one other exception from the definition of taxable "retail sales" that must also be considered.

Materials purchased to package tangible personal property that is resold are also excluded from the definition of taxable "sales at retail."

"Sale at retail," "use," "storage," and "consumption" do not include the sale, use, storage or consumption of:

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<sup>6</sup> A taxpayer making purchases for resale must present the vendor a resale certificate pursuant to TENN. COMP. R. & REGS. 1320-5-1-.68.

<sup>7</sup> Cf. *Nashville Clubhouse Inns v. Johnson*, 27 S.W.3d 542 (Tenn. Ct. App. 2000)(In this case food and beverages accompanied the customer's purchase of a room. The taxpayer who also made independent sales of food and beverages at its restaurant was allowed the exemption for purchases of food and beverages for resale.)

<sup>8</sup> It should be noted that the Taxpayer may be able to restructure the transactions with its customers so that there is a resale. However, retailer/consumers purchasing pallets that are used by them would not be allowed to make such purchases exempt from sales tax using a resale certificate.

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(ii) Materials, containers, labels, sacks, bags or bottles used for packaging tangible personal property when such property is either sold therein directly to the consumer or when such use is incidental to the sale of such property for resale . . .

Tenn. Code Ann. § 67-6-102(24)(E)(ii).

Tenn. Comp. R. & Regs. 1320-5-1-.11, entitled “Containers, Wrapping and Packaging Materials and Related Products” interprets Tenn. Code Ann. § 67-6-102(24). The first paragraph of the regulation states:

Items actually accompanying the product sold or shipped, without which the delivery of the product is impracticable on account of the character of the contents, and for which there is no separate charge, are not subject to Sales or Use Tax. These items include such things as containers, packing materials, labels or name plate affixed to products manufactured, and printed matter containing only directions for use.

Tenn. Comp. R. & Regs. 1320-5-1-.11(1).

There are several tests that must be met for packaging material to qualify for the exclusion from tax under the statute and the rule. However, first and foremost it must be determined if the pallets constitute materials or containers used for packaging. The Taxpayer explains the boxes shipped are shrink-wrapped before being placed on pallets, but the pallets are not bound in any way to the products. There is only one reported Tennessee case on the application of this statute to packaging materials. *See: Coca-Cola Bottling Co. of West Tennessee v. Celauro*, 1993 WL 330303 (Tenn. 1993). In *Coca-Cola* case there was no dispute that the tanks that were taxed by the Department were containers. Therefore, it does not address what constitutes packaging. However, other states have similar sales and use tax provisions concerning packaging.

*Custom Beverage Packers, Inc. v. Koysdar*, 294 N.E.2d 672 (Ohio 1973) was a case of first impression in Ohio on the issue of whether unbound pallets constitute packaging material. The exception for packaging material provided by the Ohio statute is similar to the Tennessee provision. It provides an exception from the Ohio sales and use taxes for the following:

Sales to persons engaged in any of the activities mentioned in division (E)(2) of Section 5739.01 of the Revised Code, of packages, including material and parts therefor, and of machinery, equipment, and material for use in packaging tangible personal property produced for sale, or sold at retail. *Packages include bags, baskets, cartons, crates, boxes, cans, bottles, bindings, wrappings, and other similar devices and containers, and 'packaging' means placing therein.'*



*Id.* p. 675. (Emphasis mine). Applying this statute, the Court held unbound pallets did not qualify as packages.

It is noted that all the above items [in the statute] are items which circumscribe and contain whatever is packaged. These items may not necessarily fully enclose, but they do restrain movement of the packaged object in more than one plane of direction. Many are complete enclosures or restraints; however, none of such items would permit movement in more than a single plane of direction. For example, a basket would, ordinarily, permit movement of its contents only in an upward direction, but may also prohibit that movement.

Applied against this test, it is readily apparent that appellant's unbound pallets do not qualify. These prohibit or restrain movement of cases of soft drinks only in one direction-downward. Otherwise, the cases may freely be moved in any direction without harm to the device. The unbound pallets are, therefore, not packages .... We do not here decide whether pallets to which cases or other objects are bound are tax exempt.

*Id.* p. 675,676. The test for packaging established by this case has been repeatedly approved and applied in Ohio. *See: Newfield Publications, Inc. v. Tracy*, 719 N. E. 2d 420 (Ohio,1999).

Under the Tennessee statute, the specific examples of packaging are containers, labels, sacks, bags or bottles. The rule adds to the examples name plates and printed directions for use. These specific examples are all items that either contain the product or are packaged with the product. The pallets used by the Taxpayer are not packaged with the product, and do not contain the product. Since these pallets only restrain the product in a downward direction, they are not containers. While these pallets are necessary for the shipment of the Taxpayer's products, they are do not qualify for the packaging exception to application of the sales and use tax.

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APPROVED: Ruth E. Johnson  
Commissioner of Revenue

DATE: 7/19/02